Project	**Insurance Contracts: Phase II**
Topic	**Unbundling insurance contracts**

Objective

1. The purpose of this discussion is to consider the issues related to separating insurance contracts into insurance and non-insurance components when they are combined to form single contract. This separation is called unbundling.

2. For each example, we request feedback from IWG members on whether:

   (a) unbundling would provide useful information and, if so, whether unbundling could be applied in a practical way.

   (b) the exposure draft describes clearly when unbundling would be required.

3. Also, we seek IWG members' views on the application of the current embedded derivative guidance.

4. Financial instruments with discretionary participation features (ie participating investment contracts) are discussed in Agenda paper 7.

5. Paragraph 8 of the exposure draft proposes to require unbundling when the investment component is not closely related to the insurance coverage. Examples of non-insurance components that should be unbundled:

   (a) a specified investment component meeting the definition of a financial instrument;

   (b) an embedded derivative separated under IAS 39 *Financial Instruments: Recognition and Measurement*; and

   (c) specified non-insurance services or goods.

An investment component

6. For example, paragraph 8(a) proposes unbundling when the insurance contract contains:

> *(a) an investment component reflecting an account balance that meets both of the following conditions:*
>
> *(i) the account balance is credited with an explicit return (ie it is not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract); and*
>
> *(ii the crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.*

Example 1

7. Consider a product with the following features:

(a) The contract is for a fixed term or until the death of the policyholder, whichever occurs earlier.

(b) In the first 2 years, the policyholder is required to pay a fixed premium amount. The premium can be paid annually, quarterly or monthly.

(c) After year 2, the policyholder has the flexibility to cease paying the premium amounts or to vary the premium amounts.

(d) The premiums purchase a number of units in an investment fund depending on the unit values.

(e) At inception, the policyholder selects an investment fund and a death benefit cover from the following alternatives:

Investment fund alternatives

(i) *Index-linked funds*—the return reflects the performance of specified external stock market indices

(ii) *Term deposits*—the return reflects a portfolio of term deposits.

Death benefit alternatives

(i) *Increasing*—the death benefit is the sum assured plus the value of the units in the investment fund.

(ii) *Indexed*—the death benefit is the higher of (1) the sum assured indexed at a fixed rate and (2) the fair value of the units in the investment fund.

(f) Monthly charges are deducted from the investment fund to pay for the cost of insurance[1] and expenses (eg asset management expenses). If an increasing death benefit is chosen, a fixed charge is made for the insurance component. For an index death benefit option, an increasing charge is made based on a schedule fixed at inception.

(g) The policyholder can withdraw at any time. An exit fee (calculated as a percentage of the value of the units surrendered) is charged if the policyholder surrenders the contract before the fixed term has finished. In addition, a discretionary market value adjustment may be charged[2]. On surrender of the whole contract, no surrender value is paid out in relation to the forfeited death benefit component.

Questions

Q1. Do you think this contract should be unbundled and, if so, which components would you unbundle? Does your answer vary depending upon the investment fund and/or death benefit alternatives selected by the policyholder? Why or why not?

Q2. If unbundling is required, how would you (1) split the premium and (2) treat the acquisition costs?

Q3. In your view, would the proposals in the exposure draft result in unbundling this contract? Why or why not?

[1] Sometimes termed 'mortality and expense risk fees'.

[2] The market value adjustment is meant to take into account market conditions that have caused a general fall in the value of the funds' underlying investments. This is to ensure that the remaining policyholders are not disadvantaged.

Example 2

8. Consider a policy in which the policyholder pays a one-off premium at inception for the following benefits:

   (a) A guaranteed annuity for a period of up to and including 7 years. If the policyholder dies during this period, the insurer will continue paying the annuity for the rest of the 7 year period to beneficiaries nominated by the policyholder.

   (b) After 7 years, the insurer will continue to pay the annuity up to the policyholder's death.

   For the purposes of discussion, assume that the premium paid at inception is CU100 and the annuity is CU5.

Questions
Q4. Do you think that this contract should be unbundled and, if so, which components would you unbundle? Why or why not?
Q5. If unbundling is required, how would you (1) split the premium and (2) treat the acquisition costs?
Q6. In your view, would the proposals in the exposure draft result in unbundling this contract? Why or why not?

Embedded derivatives

9. The exposure draft carries forward from IFRS 4 *Insurance Contracts* the requirement to separate embedded derivatives from a host insurance contract. Currently IAS 39 *Financial Instruments: Recognition and Measurement* (and in future IFRS 9 *Financial Instruments*) contains guidance on when embedded derivatives should be unbundled from insurance contracts (see the table below for an extract).

IAS 39 *Financial Instruments: Recognition and Measurement*

AG30 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

..

(d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(e) Commodity-indexed interest or principal payments embedded in a host debt

instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

..

(g) (g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

(i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or

(ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with IAS 32.

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AG33 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b)An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

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(d)An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a nonfinancial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil

transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell nonfinancial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

..

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

Questions

Q7. Are there embedded derivatives currently unbundled from insurance contracts? If so, when?

Q8. Are there any implementation issues arising from the current embedded derivative guidance in IAS 39 for insurance contracts? If so, please specify what they are.

Q9. When, if ever, should embedded derivatives be unbundled from insurance contracts under the future insurance standard? Please explain.

Services and goods

10. In relation to non-insurance services and goods that are included in an insurance contract, paragraph 8(c) of the exposure draft gives the following example of a case where the components are not closely related:

> *contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.*

Example 3

11. Consider the following situation where an insurer writes an insurance policy and a service contract.

12. An insurer issues a dental insurance contract to Company X. Under that contract:

    (a) the insurer provides dental cover to all employees of Company X up to a CU200 per claimant. The insurer bears insurance risk; and

    (b) the insurer operates several dental clinics where the employees of Company X must go to access the dental cover. If the employee dental bills are in excess of CU200, the employee is responsible for that excess. The prices of the dental services provided by the insurer's clinics are lower than the prices charged by other clinics, because the insurer's size enables it to obtain economies of scale and purchasing efficiencies.

13. The same insurer enters into a service contract with Company Z for the provision of dental services to its employees with the following terms.

    (a) Company Z employees are able to use the dental clinics operated by the insurer.

    (b) Company Z will pay for the employees' dental bill up to CU200 per employee. The insurer will bill the Company Z directly for the employees' dental costs.

    (c) Employees are responsible for the cost of dental services above CU200. The prices charged are identical to those in the situation above.

    (d) Company Z will pay a service fee which depends on the amount of dental services provided to the employees.

14. The difference between the two contracts is that the contract with Company X transfers insurance risk to the insurer.

Questions

Q10. Do you think that the insurer should unbundle contract with Company X and, if so, which components would you unbundle? What are the reasons for your answer?

Q11. If unbundling is required, how would you (1) split the premium and (2) treat the acquisition costs?

Q12. In your view, would the proposals in the exposure draft result in unbundling this contract? Why or why not?

Other questions

Questions
Q13. Do the unbundling proposals give rise to any measurement issues? Q14. Please identify any types of contracts where unbundling may give rise to significantly different measurement outcomes when compared to treating all the components of the contract under the proposals for insurance contracts (ie no unbundling). Does the difference arise at inception and/or remeasurement?

Appendix: Background on the issues around unbundling

A1. This appendix summarises the arguments for and against unbundling insurance and non-insurance components in a contract and discusses some of the issues that arise when a contract is unbundled into components.

Unbundling

A2. Arguments for separating insurance from non-insurance components when both are present in a contract are:

(a) Each component is measured and presented the same way as a standalone, but otherwise identical, bundle of rights and obligations. Hence, treating the insurance component under the insurance standard and the other component (ie a service or financial instrument) under the relevant IFRS produces a more faithful representation. It also enhances transparency and comparability.

(b) It eliminates the potential for accounting arbitrage. A predetermined accounting result could be achieved by structuring a transaction a certain way if identical bundled rights and obligations are treated differently depending on whether they are embedded in a contract or are held separately in a standalone contract.

A3. Arguments against unbundling are that:

(a) the benefits discussed above are overstated. Similar results are produced by treating the non-insurance component under the proposed insurance requirements (ie not unbundling) and unbundling. In addition, the separation of interdependent of cash flows introduces arbitrariness and results in less faithful presentation of a transaction.

(b) introducing complexity—the separation of interdependent cash flows is arbitrary.

A4. Paragraph 8 of the exposure draft proposes the following:

> Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, for example an investment (financial) component or a service component. If a component is not closely related to the insurance coverage specified in a contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (ie shall unbundle that component).

Initial measurement on unbundling

A5. The exposure draft proposes that the simplest and most pragmatic alternative is to measure the non-insurance component. Then, allocate the rest of the

transaction price to the insurance component. If the residual is a liability, some are concerned that there may be little, if any, residual margin at inception.

Transaction costs

A6. There are also alternatives for accounting for the transaction costs for the contract with insurance and non-insurance components:

(a) Recognise all transaction costs as an expense immediately.

(b) Allocate the transaction costs to the insurance and non-insurance components. The simplest allocation method would be in proportion to the allocation of the transaction price to the insurance and non-insurance components. The allocated transaction costs would then be treated according to the measurement requirements relevant to allocated components. For example, the allocated transaction costs for the insurance component would be treated under the requirements for insurance contracts.

(c) Allocate all the transaction costs to the insurance component.

(d) Allocate all the transactions costs to the non-insurance component.

A7. Alternative (b) is preferred by some because it reflects the fact that the contract comprises two components. However, the transaction costs are likely to be interdependent and there is therefore a degree of arbitrariness in all the alternatives above.

A8. Paragraph 9 of the exposure draft proposes the following:

> *In unbundling an account balance specified in paragraph 8(a), an insurer shall regard all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, as belonging to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate used in determining that account balance reflects a crediting rate after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance.*